No. 12965

In the United States Court of Appeals for the Ninth Circuit

HAWAIIAN FREIGHT FORWARDERS, LTD., *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

On Petition for Review of the Decision of the Tax Court of the United States

BRIEF FOR THE RESPONDENT

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CITATIONS

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OPINION BELOW

The findings of fact and pinion of the Tax Court (R. 43-54) are reported at 15 T. C. 35.

JURISDICTION

The Commissioner determined deficiencies in excess profits tax against taxpayer in the amount of $21,424.70 for the fiscal year ended November 30, 1943, and in the amount of $7,403.23 for the fiscal year ended November 30, 1944. (R. 44.) Notice of the deficiencies was mailed to taxpayer on February 2, 1948. (R. 11-24.) On June 14, 1948, within the permitted 90-day period, taxpayer filed a petition for review with the Tax Court

for a redetermination of the deficiencies under the provisions of Section 272 of the Internal Revenue Code. (R. 3, 6-24.) The Commissioner filed an answer (R. 24-25) and a hearing was held on May 13, 1949 (R. 70-83). After rendition of the opinion of the Tax Court a hearing was held on motions filed by taxpayer. (R. 83-118.) The decision of the Tax Court was entered February 7, 1951. (R. 57.) Petition for review by this Court was filed on May 4, 1951. (R. 58-67.) This Court accordingly has jurisdiction of the case under the provisions of Section 1141 (a) of the Internal Revenue Code, as amended by Section 36 of the Act of June 25, 1948.

QUESTIONS PRESENTED

1. Whether taxpayer was an "acquiring corporation" as defined in Section 740 (a)(1)(D) of the Internal Revenue Code, of the Leffel-Ballentyne-Schnack partnership which was in existence before January 1, 1940, so as to be entitled to compute its excess profits credit by the income method for the taxable years ended November 30, 1943, and November 30, 1944.

2. If taxpayer was an "acquiring corporation" as to the Leffel-Ballentyne-Schnack partnership, whether taxpayer made an election, as required by Section 228 (f) of the Revenue Act of 1942 and the pertinent Treasury Regulations, so as to be entitled to compute its excess profits credit by the income method for years prior to the taxable years for the purposes of excess profits carry-over to the taxable year ended November 30, 1943.

3. Whether there is any substance in taxpayers' miscellaneous allegations of error on the part of the Tax Court.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and Treasury Regulations are set forth in the Appendix, *infra*.

STATEMENT

The pertinent facts, which are reflected principally by a stipulation of facts (R. 32-37) incorporating two exhibits (R. 37-42) and an additional stipulation covering portions omitted from the printed record (R. 132-133), may be stated as follows:[1]

On March 16, 1933, Hawaiian Freight Association, Ltd., was organized as a corporation under the laws of the Territory of Hawaii to engage in the freight forwarding business. It was liquidated and dissolved on or about December 31, 1936, and its assets were distributed to its then shareholders, who were J. C. Leffel, owning 33 shares; G. C. Ballentyne, owning 24 shares; and A. G. Schnack, owning 10 shares. (R. 32.)

On or about January 2, 1937, these three former shareholders of Hawaiian Freight Association, Ltd., created a partnership, Hawaiian Freight Association, and to it transferred the assets and business theretofore owned and operated by Hawaiian Freight Association, Ltd. The interests of the partners were in the same proportions as their shareholdings in the predecessor corporation and so remained until March 8, 1940. (R. 33.)

The individual accounts of the partners as shown by their books and the audit reports of Tennant and Greaney, C.P.A.'s, for the calendar years 1937 to 1939, inclusive, were as follows (R. 36):

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[1] The Tax Court found the facts as stipulated (R. 44) and also summarized the facts in its opinion (R. 44-48). Our statement of the facts is taken directly from the stipulations, except for one unstipulated fact stated by the Tax Court and based upon an exhibit.

	J. C. Leffel	G. C. Ballentyne	A. G. Schnack
Capital, %	49.26	35.82	14.92
Capital, Jan. 1, 1937	$ 8,366.42	$ 6,083.67	$2,534.03
Salary	4,200.00	3,815.00	------
Profit	20,547.83	14,941.60	6,223.58
Totals	$33,114.25	$24,840.27	$8,757.61
Drawings	15,247.29	11,926.48	3,346.03
Balance Dec. 31, 1937	$17,866.96	$12,913.79	$5,411.58
1937 profits drawn 1938	9,500.54	6,830.12	2,877.55
Capital, Jan. 1, 1938	$ 8,366.42	$ 6,083.67	$2,534.03
Salary	4,650.00	4,650.00	------
Profit	12,588.77	9,132.26	3,803.83
Totals	$25,575.19	$19,865.93	$6,337.86
Drawings	10,657.99	8,998.60	1,000.00
Balance Dec. 31, 1938	$14,917.20	$10,867.33	$5,337.86
1938 profits drawn 1939	6,550.78	4,783.66	2,803.83
Capital, Jan. 1, 1939	$ 8,366.42	$ 6,083.67	$2,534.03
Salaries	5,500.00	5,500.00	------
Profit	9,121.37	6,632.71	2,762.71
Totals	$22,987.79	$18,216.38	$5,296.74
Drawings	5,742.98	6,830.07	------
Balance Dec. 31, 1939	$17,244.81	$11,386.31	$5,296.74

Prior to March 8, 1940, an understanding had been reached between Leffel and Ballentyne (two of the partners) and Oahu Railway and Land Company that a corporation would be formed to take over and operate the assets and business of Hawaiian Freight Association (the partnership), with Leffel, Ballentyne and Oahu as equal shareholders. It was believed that this would be to the mutual advantage of the parties concerned. (R. 33.)

On March 8, 1940, an agreement (Ex. A-1, R. 37-39) was entered into by and between Leffel, Ballentyne and Schnack (the three partners) with respect to Schnack's interest in Hawaiian Freight Association (the partnership). Under the agreement Schnack, in consideration of the receipt of $8,000, withdrew from the partnership and released to Leffel and Ballentyne all of his interest in and to the remaining property and assets of

the partnership, with Leffel and Ballentyne to assume and pay all obligations of the partnership and save him harmless from any loss, damage or liability by reason of his having been a member of the partnership. (R. 33, 39.) The agreement explains the $8,000 amount by the following language (R. 38):

> Whereas for the period ending December 31, 1939, as shown by the audit of said co-partnership made by Tennent & Greaney, certified public accountants, the interest of said co-partnership amounts to the sum of Five Thousand Two Hundred Ninety-Six and 74/100ths Dollars ($5,-296.74), and
>
> Whereas additional profits have been earned by said co-partnership for the period from December 31, 1939, to the date hereof, said profit together with the interest of said Party of the First Part [Schnack] in the good will and other assets of said co-partnership amounting to the agreed sum and value of Two Thousand Seven Hundred Three and 06/100th Dollars ($2,703.06), the total interest of said Party of the First Part to date totaling Eight Thousand Dollars ($8,000.00).

* * * * *

The payment of the $8,000 referred to in the agreement was by check of the partnership drawn March 8, 1940. After the withdrawal of Schnack, Ballentyne and Leffel were equal partners in the business conducted by Hawaiian Freight Association. (R. 33.)

On March 13 or 14, 1940, the taxpayer corporation was organized under the laws of the Territory of Hawaii with a capital of $120,000 represented by 6,000 shares which were issued 2,999 to Leffel and 2,998 to Ballentyne, three qualifying shares being nominally issued to others. (R. 33-34.) According to the minutes

of an adjourned meeting of the shareholders of the taxpayer corporation held on March 19, 1940 (see Ex. B-2, R. 40-42), the shares were issued to Leffel and Ballentyne (R. 41)—

> in consideration of the transfer by said J. C. Leffel and said G. C. Ballentyne of all of the property and assets of said Hawaiian Freight Association, a co-partnership, including the sum of $30,000 cash, said J. C. Leffel and G. C. Ballentyne being the sole co-partners of said co-partnership, * * *

For its 6,000 shares of stock the taxpayer corporation received the business and the following assets formerly owned by Hawaiian Freight Association (R. 34):

Cash	$19,237.07
Receivables	9,151.08
Furniture and Fixtures..	1,341.86
Stationery and Supplies.	269.99
Goodwill	90,000.00
	$120,000.00

The transfer of these assets was completed on April 1, 1940, and the change of operations to corporate form was fully effected by April 1, 1940. The great bulk of the business was between Chicago and Honolulu and the time required from the initiation of business to delivery and collection of charges was normally three weeks. (R. 34.)

On July 2, 1940, a statement of dissolution of the Hawaiian Freight Association, dated June 26, 1940, was filed in the office of the Treasurer of the Territory of Hawaii. The statement of dissolution showed Leffel, Ballentyne and Schnack as the partners and recited that the partnership was dissolved on March 14, 1940.

The statement was executed by Schnack and Ballentyne. (R. 48, 123-124.)

Both the original and the amended partnership return of income for 1940 (Resp. Exs. D and E, respectively) covered in a single return the period from January 1, 1940, to March 31, 1940, and listed Leffel, Ballentyne and Schnack as partners (R. 133). The net income was in the amount of $27,662.94, the return disclosing net income of $27,658.54 which included a long term net capital loss of $4.40 sustained April 5, 1940. (R. 36.)

Approximately $30,000 of capital was required by the taxpayer corporation for its operations. (R. 37.)

The taxpayer corporation filed excess profits tax returns for its fiscal year ended November 30, 1941, and subsequent fiscal years. All of such returns claimed a credit on the average earnings method, utilizing as one of the factors the earnings of Hawaiian Freight Association (R. 34); that is, the average earnings of the partnership for the years 1936 to 1939, inclusive. For the fiscal years ended November 30, 1943, and November 30, 1944 (as well as the fiscal year ended November 30, 1942, which is not in controversy), the Commissioner determined deficiencies in excess profits tax resulting from a computation of taxpayer's excess profits credit by the invested capital method. (See R. 13, 19-20, 22-24, 44.) On petition to the Tax Court, taxpayer contended that it was entitled to compute its excess profits credit by the income method, that is, on the basis of the average earnings of the partnership during the years 1936 to 1939, inclusive. (R. 6-10.) The Tax Court rejected the contention and upheld the Commissioner's deficiency determination. (R. 44-54.)

SUMMARY OF ARGUMENT

1. Taxpayer is entitled to compute its excess profits credit by the income method for the taxable years ended November 30, 1943, and November 30, 1944, only if it was an "acquiring corporation", as defined in Section 740 (a)(1)(D) of the Internal Revenue Code, of a partnership which was in existence before January 1, 1940. Section 740 (a)(1)(D) defines an "acquiring corporation" as a corporation which acquired substantially all of the properties of a partnership in an exchange to which Section 112 (b)(5) is applicable. Section 112 (b)(5) in turn requires an exchange of property for stock of a corporation by persons who immediately after the exchange are in control of the corporation and who each receive stock or securities of the corporation substantially in proportion to their interests in the property prior to the exchange. In the present case the Leffel-Ballentyne-Schnack partnership was in existence before January 1, 1940, and it may be assumed that the taxpayer-corporation acquired substantially all of the properties of that partnership. However, under Section 740 (a)(1)(D), together with Section 740 (b)(5), the properties must have been acquired in an exchange with the Leffel-Ballentyne-Schnack partnership and in an exchange to which Section 112 (b)(5) is applicable. A partnership is not a juristic entity and is not treated as such for the purposes of Section 740 (a)(1)(D). Nor is it material that the taxpayer-corporation may have been the same "business unit" as the Leffel-Ballentyne-Schnack partnership.

Actually, the exchange of property for stock was not between taxpayer and the Leffel-Ballentyne-Schnack partnership, but was an exchange of the properties of the former partnership business by Leffel and Ballentyne as partners in a *new* partnership or as joint proprietors. Schnack had withdrawn from the Leffel-

Ballentyne-Schnack partnership on March 8, 1940. Leffel and Ballentyne thereupon became equal owners of the properties of the former partnership and shortly thereafter transferred the properties to the taxpayer-corporation, organized on March 14, 1940, in return for equal shares of stock of the taxpayer-corporation.

Assuming, as the Tax Court did, that the exchange was made by the members of the Leffel-Ballentyne-Schnack partnership, the proportionate requirement of Section 112 (b)(5) was not satisfied. On the exchange for stock of the taxpayer-corporation, Schnack received no stock or interest in the taxpayer-corporation and Leffel and Ballentyne each received more than their proportionate interests in the partnership.

Taxpayer is in the same situation as the taxpayer in *E. T. Renfro Drug Co.* v. *Commissioner,* 183 F. 2d 846 (C.A. 5th). It cannot avoid the two horns of a dilemma; the exchange involved was either with a new partnership or joint proprietorship which was not in existence before January 1, 1940, or, if with the Leffel-Ballentyne-Schneck partnership, did not satisfy the requirements of Section 112 (b)(5). The case lacks the continuity of interest in ownership required by Section 740 (a)(1)(D) as between ownership of the properties in partnership form prior to January 1, 1940, and in corporate form. For that reason taxpayer is not entitled to compute its excess profits credit by the income method on the basis of the average base period net income experience of the Leffel-Ballentyne-Schnack partnership.

2. If the Court should hold that taxpayer is entitled to compute its excess profits credit by the income method for the taxable years ended November 30, 1943, and November 30, 1944, taxpayer is not in any event entitled to compute its excess profits credit by the income method for prior years for carry-over purposes to

the taxable years. Its right to do so depended upon its making an election as required by Section 228 (f) of the Revenue Act of 1942 and Regulations promulgated thereunder by the Commissioner. Taxpayer admittedly did not make an election as required by the Regulations. It asserts an election simply on the basis of the fact that, both before and after the passage of the 1942 Act, it filed excess profits tax returns in which it computed its excess profits credit by the income method.

3. There is no substance to any of taxpayer's miscellaneous allegations of error on the part of the Tax Court.

ARGUMENT

I

Taxpayer Was Not An "Acquiring Corporation", as Defined in Section 740 (a)(1)(D) of the Internal Revenue Code, of a Partnership Which Was in Existence Before January 1, 1940, and Therefore Is Not Entitled to Compute Its Excess Profits Credit By the Income Method for the Taxable Years Ended November 30, 1943, and November 30, 1944

In computing the amount of its income subject to excess profits tax for the taxable years ended November 30, 1943, and November 30, 1944, taxpayer is entitled to an excess profits credit, which, generally speaking, is designed to eliminate normal profits from subjection to the excess profits tax.[2] The Internal Revenue Code

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[2] The excess profits tax here involved was imposed under subchapter E of the Internal Revenue Code, which was added to the Code by Section 201 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974, entitled "Excess Profits Tax Act of 1940", was applicable to taxable years beginning after December 31, 1939, and was in effect repealed as to taxable years beginning after December 31, 1945, by Section 122 (a) of the Revenue Act of 1945, c. 453, 59 Stat. 556. The tax was laid upon the "adjusted excess profits net income", which was the normal net income with certain adjustments less (1) a specific exemption, (2) an excess profits credit and (3) an unused excess profits credit adjustment. (See Sections 710 and 711 of the Code (26 U. S. C. 1946, ed., Secs. 710, 711).).

provides two methods for computation of the credit—(1) on the basis of invested capital, pursuant to Section 714 (Appendix, *infra*) and (2) on the basis of income, pursuant to Section 713 (Appendix, *infra*). Computation of the credit based on income is made on the basis of average income for the base period years 1936 and 1939, inclusive, and, accordingly, under Section 712(a) (Appendix, *infra*) only those corporations which were "in existence" before January 1, 1940, are authorized to use the income method to compute the amount of their credit. A corporation may have been "in existence" before January 1, 1940, either by reason of actual existence before that date or by virtue of being an "acquiring corporation", as defined in Section 740 (a) (Appendix, *infra*), of a corporation, partnership or sole proprietorship (called a "component corporation") which was in existence before January 1, 1940 (see Secs. 712 (d), 740 (b)(5) and (f), Appendix, *infra*). A corporation which is an "acquiring corporation" of such a "component corporation" may compute its excess profits credit by the income method, pursuant to Section 712 (a), by using the average base period net income experience of its "component corporation". (See Secs. 740 (d) and (e) and 742 (g), Appendix, *infra.*)

The instant tax payer-corporation was not in actual existence on January 1, 1940. Its contention that it is entitled to compute its excess profits credit by the income method rests upon an argument that it was an "acquiring corporation" within the meaning of Section 740 (a)(1)(D); that is, that it was a corporation which acquired—

> substantially all the properties of a partnership in an exchange to which section 112 (b)(5), * * *, or to which a corresponding provision of a prior revenue law, is or was applicable.

Section 112 (b)(5) (Appendix, *infra*) provides as follows:

> (5) *Transfer to corporation controlled by transfer.*—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange. * * *

The difficulty in taxpayer's position is that it is entitled to compute its excess profits credit by the income method only if it was an "acquiring corporation" *as to a partnership which was in existence before January 1, 1940,* as will be seen, and, while there was a Section 112 (b)(5) exchange in the present case, that exchange was between taxpayer and either a new partnership created on March 8, 1940, or Leffel and Balentyne as joint proprietors. Controversy in the case results from taxpayer's attempt to argue itself into a position of being an "acquiring corporation" of the Leffel-Ballentyne-Schnack partnership, which was in existence before January 1, 1940.

A. The withdrawal of Schnack from the Leffel-Ballentyne-Schnack partnership cannot be ignored on the theory that the partnership is to be treated as a legal entity or on the ground that the taxpayer-corporation was the same "business unit" as the partnership

A partnership, operating under the name of Hawaiian Freight Association, with Leffel, Ballentyne and Schnack as partners existed prior to January 1, 1940. Leffel owned a 49.26 per cent interest, Ballentyne a 35.8 per cent interest, and Schnack a 14.92 per cent interest. On March 8, 1940, Schnack withdrew

from the partnership and was paid off in partnership funds. According to the stipulated facts, Leffel and Ballentyne thereupon became "equal partners" in the business conducted by Hawaiian Freight Association. On March 14 or 15, 1940, the taxpayer-corporation was organized. On March 19, 1940, at an adjourned meeting of the stockholders of the corporation, the officers of the corporation were authorized to issue one-half of the stock to Leffel and one-half to Ballentyne in consideration of the transfer by them to the corporation of the business and properties of the former partnership. By April 1, 1940, the transfer of business and properties of the former partnership to the taxpayer-corporation was fully effected.

Taxpayer apparently takes the position that the withdrawal of Schnack from the partnership should be ignored. (Br. 17-19.) In any event taxpayer argues that it should be permitted to compute its excess profits credit by the income method because it was the same "business unit" as the Leffel-Ballentyne-Schnack partnership (Br. 18) and because the partnership was or should be treated as a juristic entity (Br. 31-33). A partnership is not a juristic entity (*Commissioner* v. *Whitney,* 169 F. 2d 562 (C.A. 2d), certiorari denied, 335 U. S. 892; *Randolph Products Co.* v. *Manning,* 176 F. 2d 190 (C.A. 3d), and it cannot be treated as such for the purposes of Section 740 (a)(1)(D), as we shall show. Nor is it material that the taxpayer-corporation may have been the same "business unit" as the Leffel-Ballentyne-Schnack partnership.

In order to be entitled to compute its excess profits credit by the income method, pursuant to Section 712 (a), taxpayer must have been in existence prior to January 1, 1940. It was in existence prior to January 1, 1940, if it had a "component corporation" which was in existence before that date. (Section 740

(f).) It had a "component corporation" in existence before that date if it was an "acquiring corporation" as defined in Section 740 (a)(1)(D) of a partnership which was in existence before that date. (Section 740 (b)(5).) To be an "acquiring corporation" within the meaning of Section 740 (a)(1)(D) of a partnership which was in existence before that date, taxpayer must have acquired the properties of such a partnership in an exchange to which Section 112 (b)(5) is applicable. Section 112 (b)(5) covers an exchange of property for stock or securities of a corporation where the transferring persons are immediately thereafter in control of the corporation, but applies only if the stock and securities received by each person "is substantially in proportion to his interest in the property prior to the exchange".

The plain effect of Section 740 (a)(1)(D) is *not* that in the case of *all* transfers of a partnership business to a corporation the corporation will take over the base period income experience of the partnership business. This is permitted *only* in the case of a transfer of substantially all the properties of a partnership in an exchange falling within Section 112 (b)(5). That means an exchange whereby one or more persons transfer property to a corporation solely for stock of the corporation and when "no substantial change occurs in the beneficial ownership and control of the property". *Snead* v. *Jackson Securities & Investment Co.,* 77 F. 2d 19, 21 (C.A. 5th), certiorari denied, 296 U. S. 599. In other words, a corporation is permitted under Section 740 (a)(1)(D) to use the base period income experience of a partnership only when it has acquired substantially all of the properties of the partnership in a transaction which, coming within the terms of Section 112 (b)(5), really involved no more than a mere change in the *form of ownership* of the properties. It is well set-

tled that if upon the exchange there results a change in ownership, either in the identity of the owners or in the proportionate interest of each, or if each of the transferors does not receive stock substantially in proportion to his interest in the property before the exchange, the transaction is not one within Section 112 (b)(5). See *Snead* v. *Jackson Securities & Investment Co., supra; American Compress & Warehouse Co.* v. *Bender,* 70 F. 2d 655 (C.A. 5th), certiorari denied, 293 U. S. 607; *Hillyer, Edwards, Fuller* v. *United States,* 52 F. 2d 742 (E.D. La.); see also, *United Carbon Co.* v. *Commissioner,* 90 F. 2d 43 (C.A. 4th); *Bodell* v. *Commissioner,* 154 F. 2d 407 (C.A. 1st); *Mather & Co.* v. *Commissioner,* 171 F. 2d 864 (C.A. 3d), certiorari denied, 337 U. S. 907; and *Elmore Milling Co.* v. *Helvering,* 70 F. 2d 736 (C.A. D.C.).

By requiring an exchange to which Section 112 (b)(5) is applicable, Section 740 (a)(1)(D) requires continuity of interest in the owners of the property, not mere continuation of the business as a "business unit". That fact also precludes any notion that a partnership should be treated as a juristic entity for the purposes of Section 740 (a)(1)(D). Section 112 (b)(5) relates to a transfer of property by *persons,* not by a juristic entity, and Section 740 (a)(1)(D), in requiring a Section 112 (b)(5) exchange of the properties of a *partnership,* requires an exchange by the persons who are the partners. If one partner withdraws from the partnership, or ownership of the partnership properties is changed in some other way, there is not the required continuity of interest in ownership as between the "acquiring corporation" and the partnership whose properties it acquired. Since continuity of interest in ownership is required, it cannot be ignored in favor of treating a partnership as a juristic entity.

B. To benefit from being an "acquiring corporation" as defined in Section 740 (a)(1)(D), taxpayer must have been an acquiring corporation of a partnership which was in existence before January 1, 1940

If the exchange of properties of the partnership business for stock of the taxpayer-corporation was made by Leffel and Ballentyne as partners in a new partnership or as joint proprietors, the exchange, while fulfilling the requirements of Section 112 (b)(5), was not an exchange which aided taxpayer for excess profits tax purposes.

In order to be an "acquiring corporation" as defined in Section 740 (a)(1)(D), taxpayer must have acquired substantially all of the properties of a *partnership* in an exchange to which Section 112 (b)(5) was applicable. If taxpayer acquired substantially all of the properties of a new partnership (or perhaps of a joint proprietorship) created on March 8, 1940, between Leffel and Ballentyne, the partnership whose properties it acquired (the Leffel-Ballentyne partnership or proprietorship) was taxpayer's "component corporation" as that term is defined in Section 740 (b)(5).[3] Since that "component corporation" was not in existence before January 1, 1940, taxpayer is not aided by Section 740 (f) which provides that an "acquiring corporation" shall be considered to have been in existence before January 1, 1940, if its "component corporation" was in existence before January 1, 1940.

Nor does it aid taxpayer that its "component corporation" (the Leffel-Ballentyne partnershp) had acquired the properties of the Leffel-Ballentyne-Schnack partnership which existed before January 1, 1940. In

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[3] In connection with the distinction between a new partnership and a joint proprietorship, it may be noted that Section 740 (h) provides that, for the purposes of Section 740 (a)(1)(D), Section 740 (b) (5) and Section 742 (g), the business of a *sole* proprietorship shall be considered a partnership.

that connection Section 740 makes a distinction between acquired corporations and acquired partnerships. Under Section 740 (g) (Appendix, *infra*), a corporation acquired by a corporation which was in turn acquired by the taxpayer-corporation is also considered a "component corporation" of the taxpayer-corporation. But that section by its terms applies only to acquired corporations and, moreover, a partnership cannot be an acquiring corporation within the meaning of Section 740 (a), as Treasury Regulations 112, Section 35.740-4 (Appendix, *infra*), provide.[4]

C. Taxpayer was not an "acquiring corporation" as to the partnership which was in existence before January 1, 1940

Taxpayer is therefore entitled to compute its excess profits credit by the income method only if it was an "acquiring corporation", as defined in Section 740 (a)(1)(D), of the Leffel-Ballentyne-Schnack partnership, which, unlike any new partnership which might have been formed on March 8, 1940, had been in existence before January 1, 1940.[5] To be an "acquiring corporation" of that partnership (or "component corporation"), taxpayer must have acquired substantially

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[4] The reason is apparent. The definition of an "acquiring corporation" contained in Section 740 (a)(1) relates only to "corporations" and contains no reference to the exchange of properties of a partnership other than paragraph (D), which requires a Section 112 (b)(5) exchange of stock or securities of a corporation for properties of a partnership.

[5] The Tax Court did not reach the question whether the withdrawal of Schnack created a new partnership on March 8, 1940. The Tax Court did, however, note that there was no intention to continue the business in partnership form; that only three weeks elapsed between the time of Schnack's withdrawal and the completion of the transfer of property to taxpayer and that the three-week gap was due to the fact that it took three weeks to complete all business which had been initiated and was in progress. (R. 50.)

all of the properties of that partnership in an exchange to which Section 112 (b)(5) is applicable.

Assuming *arguendo* that taxpayer acquired "substantially all of the properties" of the Leffel-Ballentyne-Schnack partnership, the acquisition was not made in an exchange to which Section 112 (b)(5) is applicable. A Section 112 (b)(5) exchange is a transfer by one or more persons of property to a corporation solely in exchange for stock or securities in such corporation, with such person or persons in control of the corporation immediately after the exchange, provided that—

> in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange. * * *

For taxpayer to have been an "acquiring corporation" as to the Leffel-Ballentyne-Schnack partnership, there must have occurred an exchange of properties of that partnership for stock of the taxpayer-corporation by the members of that partnership and the partners must each have received stock in proportion to their partnership interests. There obviously was no exchange between the members of the Leffel-Ballentyne-Schnack partnership and the taxpayer-corporation, for Schnack had withdrawn from the partnership prior to the exchange with the taxpayer-corporation and it was Leffel and Ballentyne who actually made the exchange.

However, assuming (as the Tax Court did) that there was an exchange between the members of the Leffel-Ballentyne-Schnack partnership and the taxpayer-corporation, the exchange was not one which satisfied the proportionate requirements of Section 112 (b)(5).

In the partnership, Leffel had a 49.26 per cent interest, Ballentyne a 35.82 per cent interest and Schnack a 14.92 per cent interest. (See R. 36.) On the exchange of the partnership property for stock, Schnack received no stock or other interest in the taxpayer-corporation and Leffel and Ballentyne each received 50 per cent of the stock of the taxpayer-corporation. Since the proportionate requirement of Section 112 (b)(5) was not satisfied, there was no Section 112 (b)(5) exchange as between taxpayer and the Leffel-Ballentyne-Schnack partnership, taxpayer was not an "acquiring corporation" of that partnership within the meaning of Section 740 (a)(1)(D), and taxpayer accordingly was not "in existence" before January 1, 1940, in order to be entitled under Section 712 (a) to compute its excess profits credit by the income method.

It does not aid taxpayer to argue, as it does (Br. 26), that the proportionate requirement of Section 112 (b)(5) was satisfied because immediately prior to the incorporation of the taxpayer-corporation Leffel and Ballentyne were equal partners (after the withdrawal of Schnack) and upon taxpayer's incorporation they each received 50 per cent of taxpayer's stock. Such an argument amounts to an assertion that there was a Section 112 (b)(5) exchange of properties of a *new* partnership or joint proprietorship, not of the Leffel-Ballentyne-Schnack partnership. If that assertion is accepted, taxpayer is faced with the other horn of its dilemma, for, as we have already shown, an exchange with a new partnership or joint proprietorship does not entitle taxpayer to use the average base period net income experienc of the Leffel-Ballentyne-Schnack partnership to compute its excess profits tax credit by the income method.

The situation here is similar to that presented in *E. T. Renfro Drug Co.* v. *Commissioner,* 183 F. 2d 846 (C.A.

5th). In that case two members of several partnerships purchased the undivided one-third interest of the third partner in each partnership and transferred the properties of the partnership to a corporation. There, as here, the question was to the effect in the computation of the taxpayer's excess profits credit. The Tax Court had held that upon the purchase of the third partner's interest either one of two things occurred—either there was then created a new partnership which acquired the assets of the old partnerships or the assets of the old partnerships were acquired by the purchasers as joint proprietors—and that in either event the property of the partnerships passed through the hands of a partnership or individuals who could not transfer to the corporation the business experience of the partnerships during the base period years because the intervening proprietors were not "acquiring corporations" as defined in the Code. There the taxpayer argued that the original partnerships continued until their affairs were wound up and the net assets distributed to those entitled thereto, that is, to the two purchasing partners. The Fifth Circuit answered (p. 847):

> Petitioner's argument fails to convince us that the Tax Court was in error in evaluating the legal effect of the transaction. It confuses the rule of dissolution and subsequent "winding up" for the benefit of, and distribution of assets to, the members of the dissolved partnership, with the rights of the purchasers of a partnership interest to deal with such purchased interest as they may choose. Thus, dependent upon the facts of any case, the purchasers might continue a partnership, but unless we attribute to a partnership an independent juristic entity, which the law does not permit, it would not be the original partnership, but a new

one. In the absence of such agreement for continuance as partners, the purchasers would hold as joint proprietors. *The petitioner has failed to show us how its claim can legally avoid the two horns of the dilemma with which it is confronted: the new partnership or joint proprietorship on the one side, or on the other, impalement upon the horn of inability to meet the test of the Internal Revenue Code § 112 (b)(5), which excepts the transfer "only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange."* (Italics supplied.)

The decisions relied upon by taxpayer are distinguishable. *Ransohoffs, Inc.* v. *Commissioner,* 9 T. C. 376, involved a California partnership the members of which had expressly agreed to continue the partnership, not merely the business, after the death of one of the partners. *Faigle Tool & Die Corp.* v. *Commissioner,* 7 T. C. 236, involved the acquisition of properties of a sole proprietorship, rather than of a partnership, and the only question in the case was whether the exchange was of "substantially all" of the properties of the sole proprietorship, as required by Section 740 (a)(1)(D). *A. C. Burton & Co.* v. *Commissioner,* 190 F. 2d 115 (C.A. 5th), also involved the acquisition by a corporation of the properties of a sole proprietorship and the only question was whether the corporation had acquired "substantially all" of the properties of the sole proprietorship in exchange for stock. As previously stated, the instant case is on all fours with *E. T. Renfro Drug Co.* v. *Commissioner, supra,* decided by the Fifth Circuit.

II

Taxpayer Was Not in Any Event Entitled to Compute Its Excess Profits Credit By the Income Method for Prior Years for the Purposes of Excess Profits Carry-Over to the Taxable Year Ended November 30, 1943

If taxpayer was not an "acquiring corporation" as to the Leffel-Ballentyne-Schnack partnership, as the Tax Court held, it is not entitled to compute its excess profits credit by the income method, either for the taxable years or for prior years for purposes of excess profits credit carry-over to the taxable years, because it was not an "acquiring corporation" of a partnership which was in existence before January 1, 1940. If this Court should reverse the Tax Court and hold that taxpayer was an "acquiring corporation" as to the Leffel-Ballentyne-Schnack partnership, an additional question is presented with respect to excess profits credit carry-over to taxpayer's fiscal year ended November 30, 1943. The carry-over of credit could come only from prior years. As taxpayer states (Br. 40), prior to the enactment of the Revenue Act of 1942, c. 619, 56 Stat. 798, it was entitled to compute its excess profits credit by the income method only if its "component corporation" was in existence on January 1, 1936, as distinguished from January 1, 1940. The Leffel-Ballentyne-Schnack partnership was not in existence on January 1, 1936. By virtue of amendments made by Section 228 of the 1942 Act, taxpayer became entitled to compute its excess profits credit by the income method if its "component corporation" was in existence before January 1, 1940. Section 228 (f) of the 1942 Act (Appendix, *infra*), provided that the amendments made by Section 228 should apply to taxable years beginning before December 31, 1941, only if the taxpayer—

> within the time and in the manner and subject to such regulations as the Commissioner with the ap-

> proval of the Secretary prescribes, elects to have such amendments * * * apply retroactively to all taxable years of the taxpayer beginning after December 31, 1949, such amendments shall also be applicable to the computation of the tax for taxable years beginning after December 31, 1939.

The Commissioner promulgated Regulations pursuant to this statutory provision. (See Regulations 109, Sec. 30.742-2(e), Appendix, *infra.*)

Taxpayer admittedly did not comply with the Regulations promulgated by the Commissioner. Taxpayer's contention is simply that, because it filed excess profits tax returns in which it had computed its credit by the income method, both before and after the amendments made by the 1942 Act, it made an election to have the 1942 amendments apply retroactively. (Br. 41-43.) The contention, we submit, requires no argument—particularly since taxpayer's excess profits tax returns are not contained in the printed record and it cannot be ascertained whether the returns substantiate taxpayer's assertion that "All of its returns contained the necessary data and information required by the regulations". (Br. 41.)

III

There Is No Substance in Taxpayer's Miscellaneous Allegations of Error on the Part of the Tax Court

Taxpayer asserts that the Tax Court committed numerous miscellaneous errors requiring reversal. (Br. 43-53.) These will be discussed below in the order in which they are presented by taxpayer.

A. Taxpayer's complaint that the Tax Court failed to make findings of fact (Br. 44-45) is unwarranted. The Tax Court found the facts as stipulated (R. 44) and also summarized the facts in its opinion (R. 44-

48). What taxpayer apparently considers should have been made as findings of fact (see Br. 45) would have been conclusions of law.

B. Taxpayer's assertion that the Tax Court made factual statements contrary to the stipulated facts and other evidence (Br. 45-47) consists principally of a distortion of statements of the Tax Court. This Court would not in any event be bound by statements of fact contrary to the stipulated facts.

C. Taxpayer's statement that the Tax Court decided the case on a basis not presented or argued to the Tax Court (Br. 47-51) is specious. There undoubtedly was a Section 112 (b) (5) exchange as between taxpayer and Leffel and Ballentyne but, in order to be entitled to compute its excess profits credit by the income method, taxpayer was required to show an exchange between it and the members of the Leffel-Ballentyne-Schnack partnership which existed before January 1, 1940. In the Tax Court the Commissioner argued that the withdrawal of Schnack from the partnership created a new partnership, thereby precluding an exchange between taxpayer and the Leffel-Ballentyne-Schnack partnership. The Tax Court assumed that the exchange was between taxpayer and the Leffel-Ballentyne-Schnack partnership and held that the exchange did not satisfy the proportionate requirements of Section 112 (b) (5). The requirements of Section 112 (b) (5) had to be met if taxpayer was to be considered an "acquiring corporation" of the Leffel-Ballentyne-Schnack partnership within the meaning of Section 740 (a) (1) (D) and those requirements could not have been ignored by the Tax Court even if the parties had stipulated that they should be. All that the Tax Court did was to decide the case on the basis of one horn, rather than the other horn, of taxpayer's dilemma. Cf. *E. T. Renfro Drug*

Co. v. *Commissioner, supra.* What taxpayer has done, either through design or confusion, is to argue each horn of the dilemma on the basis of the existence of the other horn of the dilemma.

D. Taxpayer asserts procedural error because a judge of one Division of the Tax Court, Judge Turner, decided the case after it had been heard by a judge of another Division, Judge Van Fossan. (Br. 51-53.) Whether that was procedural error or not is immaterial. The hearing before Judge Van Fossan was very brief and consisted only of explanations of the case by counsel and the introduction of a stipulation of facts and documentary exhibits (see R. 70-83), no oral testimony having been offered. Taxpayer could not possibly have been prejudiced by the fact that the case was decided by one judge, rather than by another, on the record as made. Indeed, on hearing on motions filed by taxpayer after the rendition of Judge Turner's opinion, taxpayer's counsel had a full opportunity, of which he availed himself, of presenting to Judge Turner any objections he had to the opinion. (See R. 83-118.)

CONCLUSION

The decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

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November, 1951.

APPENDIX

Internal Revenue Code:

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges Solely in Kind.*—

*   *   *   *   *

(5) *Transfer to corporation controlled by transferor.*—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange. * * *

(26 U.S.C. 1946 ed., Sec. 112.)

SUBCHAPTER E—EXCESS PROFITS TAX

[as added by Sec. 201 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974]

Part I

*   *   *   *   *

SEC. 712. EXCESS PROFITS CREDIT—ALLOWANCE.

(a) [as amended by Sec. 13 of the Excess Profits Tax Amendments of 1941, c. 10, 55 Stat. 17] *Domestic Corporations.*—In the case of a domestic

corporation which was in existence before January 1, 1940, the excess profits credit for any taxable year shall be an amount computed under section 713 or section 714, whichever amount results in the lesser tax under this subchapter for the taxable year for which the tax under this subchapter is being computed. In the case of all other domestic corporations the excess profits credit for any taxable year shall be an amount computed under section 714. (For allowance of excess profits credit in case of certain reorganizations of corporations, see section 741.)

* * * * *

(d) [as added by Sec. 228 (e)(1) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Special Rule in Connection with Certain Reorganizations.*—For the existence of taxpayer through component corporation, see section 740 (f).
(26 U.S.C. 1946 ed., Sec. 712.)

Sec. 713. Excess Profits Credit.—Based on Income.

(a) [as amended by Sec. 4 (a) of the Excess Profits Tax Amendments of 1941, *supra,* and Sec. 228 (e)(2) of the Revenue Act of 1942, *supra*] *Amount of Excess Profits Credit.*—The excess profits credit for any taxable year, computed under this section, shall be—

(1) *Domestic corporations.*—In the case of a domestic corporation—

(A) 95 per centum of the average base period net income,

(B) Plus 8 per centum of the net capital addition as defined in subsection (g), or

(C) Minus 6 per centum of the net capital reduction as defined in subsection (g).

* * * * *

(26 U.S.C. 1946 ed., Sec. 713.)

SEC. 714 [as amended by Sec. 201 (b) of the Revenue Act of 1941, c. 412, 55 Stat. 687]. EXCESS PROFITS CREDIT—BASED ON INVESTED CAPITAL.

The excess profits credit for any taxable year, computed under this section, shall be the amount shown in the following table: [showing percentages of invested capital of certain amounts]

* * * * *

(26 U.S.C. 1946 ed., Sec. 714.)

Part II—Rules in Connection With Certain Exchanges

Supplement A—Excess Profits Credit Based on Income

SEC. 740 [as amended by Sec. 228 (a) of the Revenue Act of 1942, *supra*]. DEFINITIONS.

For the purposes of this Supplement—

(a) *Acquiring Corporation.*—The term "acquiring corporation" means—

(1) A corporation which has acquired—

* * * * *

(D) [as added by Sec. 8 (a) of the Excess Profits Tax Amendments of 1941, *supra*] substantially all the properties of a partnership in an exchange to which section 112 (b)(5), or so much of section 112 (c) or (e) as refers to section 112 (b)(5), or to which a corre-

sponding provision of a prior revenue law, is or was applicable.

* * * * *

(b) *Component Corporation.*—The term "component corporation" means—

* * * * *

(5) [as added by Sec. 8 (b) of the Excess Profits Tax Amendments of 1941, *supra*] In the case of a transaction specified in subsection (a)(1)(D), the partnership whose properties were acquired.

* * * * *

(d) In the case of a taxpayer which is an acquiring corporation the base period shall be the four calendar years 1936 to 1939, both inclusive, except that, if the taxpayer became an acquiring corporation prior to September 1, 1940, the base period shall be the same as that applicable to its first taxable year ending in 1941.

(e) *Base Period Years.*—In the case of a taxpayer which is an acquiring corporation its base period years shall be the four successive twelve-month periods beginning on the same date as the beginning of its base period.

(f) *Existence of Acquiring Corporation.*—For the purposes of section 712 (a), if any component corporation of the taxpayer was in existence before January 1, 1940, the taxpayer shall be considered to have been in existence before such date.

(g) *Component Corporations of Component Corporations.*—If a corporation is a component corporation of an acquiring corporation, under subsection (b) or under this subsection, it shall (except for the purposes of section 742 (d)(1)

and (2) and section 743 (a)(1) and (3)) also be a component corporation of the corporation of which such acquiring corporation is a component corporation.

* * * * *

(26 U.S.C. 1946 ed., Sec. 740.)

SEC. 742 [as amended by Sec. 228 (c) of the Revenue Act of 1942, *supra*]. SUPPLEMENT A AVERAGE BASE PERIOD NET INCOME.

* * * The Supplement A average base period net income shall be computed as follows:

* * * * *

(g) [as added by Sec. 8(d) of the Excess Profits Tax Amendments of 1941, *supra*] In the case of a partnership which is a component corporation by virtue of section 740 (b)(5), the computations required by this Supplement shall be made, under rules and regulations prescribed by the Commissioner with the approval of the Secretary, as if such partnership had been a corporation. * * *

* * * * *

(26 U.S.C. 1946 ed., Sec. 742.)

Revenue Act of 1942, c. 619, 56 Stat. 798:

SEC. 228. RULES FOR INCOME CREDIT IN CONNECTION WITH CERTAIN EXCHANGES.

* * * * *

(f) *Taxable Years to Which Amendments Applicable.*—The amendments made by this section shall be applicable only to the computation of the tax for taxable years beginning after December 31, 1941, except that (1) the last sentence of section 740 (c), as added by subsection (a) of this section shall be applicable to the computation of

the tax for all taxable years beginning after December 31, 1939, and (2) if a taxpayer, within the time and in the manner and subject to such regulations as the Commissioner with the approval of the Secretary prescribes, elects to have such amendments (except those which by their terms are limited to taxable years beginning after December 31, 1941, and except that referred to in clause (1)) apply retroactively to all taxable years of the taxpayer beginning after December 31, 1939, such amendments shall also be applicable to the computation of the tax for taxable years beginning after December 31, 1939.

Treasury Regulations 109, promulgated under the Internal Revenue Code:

SEC. 30.742-2. * * *

* * * * *

(e) [as added by T. D. 5242, 1943 Cum. Bull. 692, 715, 734] *Election to have amendments to Supplement A made by Revenue Act of 1942 apply to taxable years beginning after December 31, 1939, and before January 1, 1942.*—A taxpayer may elect to have the amendments to Supplement A made by the Revenue Act of 1942 apply retroactively (with the exceptions indicated below) to all its taxable years beginning after December 31, 1939, and before January 1, 1942. If a taxpayer elects to have such amendments so apply, each such amendment shall be applicable to such taxable years, except such of the amendments as by their terms are limited to taxable years beginning after December 31, 1941. The election does not apply to the last sentence of section 740 (c), as added by the Revenue Act of 1942, or to the repeal of section 741 (b), which amendments by their terms are retroactive

to all taxable years beginning after December 31, 1939. The amendments which by their terms are limited to taxable years beginning after December 31, 1941, and therefore are also not subject to the election are the provisions of section 740 (c) (except the last sentence thereof) and section 742 (b)(2).

If the taxpayer desires to make the election described in the preceding paragraph, the election must be made on or before whichever one of the following applicable dates occurs first:

(1) June 15, 1943, if an excess profits tax return for a taxable year beginning after December 31, 1941, is filed for such year and if such return is filed on or before June 15, 1943,

(2) the date of the filing of the taxpayer's excess profits tax return for its first taxable year beginning after December 31, 1941, for which an excess profits tax return is filed if such return is filed after June 15, 1943, or

(3) the date of expiration of 30 months after the filing of the excess profits tax return (or, if no such return was filed, after the date on which such return was due or would have been due if such return were required to be filed) for the taxpayer's first taxable year beginning after December 31, 1939.

The election once made shall be irrevocable and shall apply to all taxable years of the taxpayer beginning before January 1, 1942.

In order to make such election, the taxpayer shall, within the time prescribed, file with the collector the following:

(i) A statement that the taxpayer elects to have such amendments apply to each of the tax-

able years beginning after December 31, 1939, and before January 1, 1942, and

(ii) A statement with respect to each such taxable year setting forth (A) the Supplement A average base period net income for such taxable year, computed under Supplement A as amended by such amendments, (B) the excess profits credit for such year based upon the Supplement A average base perid net income for such year so computed, and (C) the excess profits tax or unused excess profits credit (as defined in section 710 (c)(2)), if any, as the case may be, for such year resulting from the use of the excess profits credit so computed. Such statement shall not constitute a claim for credit or refund. If the application of the amendments made by the Revenue Act of 1942 results in an overpayment in the amount of tax for any taxable year, a timely claim for credit or refund on Form 843 should be filed in the usual manner. For limitations upon credits and refunds generally, see section 322.

Treasury Regulations 112, promulgated under the Internal Revenue Code:

SEC. 35.740-4. *Partnerships and sole proprietorships under Supplement A*—A partnership (or a business owned by a sole proprietorship) can be a component corporation for the purposes of Supplement A, subject to the exceptions in section 740 (g). However, a partnership (or a business owned by a sole proprietorship) cannot be an acquiring corporation and, therefore, section 740(g) cannot operate to make any of its predecessors component corporations of its acquiring corporation.

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